IT 01-13
Tax Type: Income Tax
Issue: Foreign Source Dividends in The Sales Factor
80/20 Rule
Unitary – Inclusion of Company(ies) In A Unitary Group

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 98-IT-0000**
	FEIN 00-0000000
v.	**Tax yrs. 1992, 1993 & 1994**
"Apex, Inc.", Taxpayer	**Charles E. McClellan Administrative Law Judge**

RECOMMENDATION FOR DECISION

Appearances:

Rickey A. Walton and Sean Cullinan, Special Assistant Attorneys General, for the Department of Revenue; Brian L. Browdy, Karen L. Black and Marilyn A. Wethekam of Horwood, Marcus & Berk for the taxpayer.

Synopsis:

This matter involves a protest to two Notices of Deficiency issued to "Apex, Inc." ("Apex" or "taxpayer") by the Department of Revenue ("Department") on July 31, 1998. The first Notice of Deficiency is for the 1992 tax year[1]. The second Notice of Deficiency is for the 1993 and 1994 tax years. (The years 1992, 1993 and 1994 are referred to herein

[1] Taxpayer files its income tax returns on a calendar year basis.

as the “tax years”.) A pre-trial order was entered on August 9, 2000 setting forth the issues to be decided as follows:

1. Whether "Apex Energy, Inc." (“AEI”) was an investment company within the meaning Section 1501(a)(8) of the Illinois Income Tax Act (“IITA” or the “Act”)[2] during the tax years.
2. Whether "Apex Foreign Sales Corporation" (“AFSC”) was an “80/20 company” within the specifications of IITA Section 1501(a)(27) during the tax years.
3. If "AEI" was not a financial organization during the tax years, whether it was to be included in "Apex’s" unitary business group.
4. Whether "AEI" and its subsidiaries were members of a unitary business group during the tax years.
5. Whether "Gelfman Coal Company" was to be included in "Apex’s" unitary business group during the tax years.
6. Whether "AEI" may apportion its business income under the comparative gross receipts method.
7. Whether, for the tax years, "Apex, Inc." demonstrated reasonable cause to justify abatement of the penalty imposed by the Department pursuant to IITA § 1005 for failing to pay the tax required to be shown due on its tax returns.

An evidentiary hearing was held on April 25, 2001 following which the parties filed post-hearing briefs. After the briefs were filed, the parties settled the issue of whether "Apex Foreign Sales Corporation" was an 80/20 company within the

[2] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq*., the Illinois Income Tax Act.

specifications of IITA § 1501(a)(27). Under the terms of the settlement, the Department concedes 70% of the tax resulting from the inclusion of the company in the taxpayer's unitary group and the taxpayer agrees to pay 30% of tax resulting from the inclusion of the company in the taxpayer's unitary group for years ending prior to January 1, 1998. This settlement is reflected in an agreed order entered on August 16, 2001. In that order, taxpayer also conceded all of the remaining issues except the following:

1. Whether "Apex Energy, Inc." and its subsidiaries were members of a unitary group during the years at issue.
2. Whether "Apex, Inc." demonstrated reasonable cause for failing to pay tax required to be shown due on its tax returns before the due date to justify abatement of the penalty imposed pursuant to IITA § 1005.

I recommend that the Notices of Deficiency be recalculated to reflect the agreement of the parties regarding "Apex Foreign Sales Corporation" and the issues conceded by the taxpayer. Following these recalculations, the penalty should be recalculated to eliminate that portion of the penalty resulting from the exclusion of "AEI" from the "Apex" unitary business group in the income tax returns originally filed by the taxpayer. As so adjusted, the Notices of Deficiency should be made final.

Findings of Fact:

1. "AEI" is a Delaware corporation headquartered in (Someplace), Delaware. Stip. ¶ 1.

2. During the tax years,[3] the ownership interests in "AEI" were: 50% by "Durberville Energy, Co."; 40% by "Rembrandt", AG; 10% by "Rembrandt Diversified". Dept. Group Ex. No. 5 - Exhibit C.

3. "AEI" owned 100% of "Apex", and "Gelfman Coal Company". ("Gelfman"). *Id.*; Stip. ¶ 3.

4. "Apex" was formed in late 1991 or early 1992 and was headquartered in (Someplace), Pennsylvania. Stip. ¶ 3; Tr. p. 186.

5. "AEI" was the parent corporation of "Apex" and "Apex" was the parent corporation of a large group of subsidiary corporations referred to as the coal group. Tr. pp. 191-192; Taxpayer Group Ex. No. 1; Dept Group Ex. No. 5 - Exhibit C.

6. The coal group consisted of numerous subsidiary corporations engaged in the mining, marketing, selling and distribution of bituminous coal. Stip. ¶ 4; Dept Group Ex. No. 5 - Exhibit C.

7. "Gelfman Coal Company", a subsidiary of "AEI", was in the business of mining and selling coal. Stip. ¶ 5; Dept Group Ex. No.5 - Exhibit C.

8. "Apex" provided numerous services to the coal group, including engineering, property management, environmental, planning, purchasing, accounting, controller services, finance, tax, legal, computer, research and development, safety and any other administrative services that might be required. Stip. ¶ 6; Tr. pp. 191-192; Taxpayer Group Ex. No. 1.

[3] Unless specified otherwise, the findings of fact relate to facts as they existed during the tax years.

9. "New Ulm Supply Company" was a 4th tier subsidiary of "Apex", headquartered in (Someplace), Pennsylvania that was engaged in the business of selling mining and industrial supplies to the coal group and in managing the inventories of companies in the coal group. Stip. ¶ 7.

10. "AEI" made thirteen loans totaling at least $107,119,600 to the coal group each one of which was evidenced by a promissory note. Stip. ¶ 8.

11. The coal group paid interest on the notes to "AEI" calculated at the federal rate. Tr. p. 218.

12. "AEI" was a holding company that managed intangible investments and its only sources of income were dividends and interest paid by its subsidiary corporations. Stip. ¶ 9, 11, 12; Tr. pp. 43, 231.

13. "AEI's" balance sheet and income statement showed no fixed assets, no inventory, no land, a minimal amount of rent expense, no officers and directors' salaries, no other salaries or wages, and no cost of labor. Tr. p. 43.

14. The individuals who were officers and directors of the coal group, "Apex" and "AEI" were identical except for one officer of "AEI" who was not an officer or director of the other companies. Tr. pp. 41, 126.

15. The coal group operated more than a dozen mining complexes in the United States and Canada. Stip. ¶ 15.

16. The coal group sold directly, or through agents, brokers and trading companies, the coal it produced as well as coal that it purchased for resale from other producers. Stip. ¶ 17.

17. The coal group sold coal to customers (e.g., electric utilities, steel, and other industrial customers) under contractual arrangements that were the result of both bidding procedures and extensive negotiations. These subsidiaries routinely engaged in efforts to renew or extend contracts that were scheduled to expire. Stip. ¶ 18.

18. The coal produced by the coal group was distributed to customers via railroad, barge line, terminal operators, ocean vessel brokers, and trucking companies. Stip. ¶ 19.

19. The coal group shipped approximately one-third of its coal along waterways. Water-borne shipments of coal originated from mines in every state in which the coal group operate. Stip. ¶ 20.

20. The river operations of the coal group transported coal from their mines with river load-out facilities along the Monongahela and Ohio Rivers. The river operations employed five company-owned towboats and nearly 300 barges. The barge operation allowed the coal group to exercise control of delivery schedules and served as temporary floating storage of coal where land storage was unavailable. Stip. ¶ 21.

21. International customers and domestic coastal customers received coal through the coal group's terminal at (Someplace), Maryland, which was constructed in the early 1980's. Stip. ¶ 22.

22. About three-fourths of the tonnage shipped through the Maryland terminal was produced at mines owned by the coal group. Stip. ¶ 24.

23. The coal group maintained a research & development department, with a staff of over 100 scientists, engineers, and support personnel. The research & development department identified, developed and applied technology to support the production and marketing objectives of the coal group's coal and gas operations and served as a technical resource to other staff departments. Stip. ¶ 25.

24. Approximately half of the 5000 employees in the coal group were represented by United Mine Workers of America. Stip. ¶ 226.

25. "New Ulm Supply Company" maintained customer service centers nationwide. Approximately one-third of "New Ulm Supply Company's" sales were made to the coal group. Stip. ¶ 27.

26. The coal group owned or leased approximately 1,100 railroad cars to move coal to customers via railroads. Stip. ¶ 28.

27. The business operations of the coal companies were managed, directed and conducted independently from "AEI". Tr. pp. 147-148.

28. "Richard G. Roe" ("Roe"), the vice-president of operations, was employed by "Apothecary Coal Co.", a subsidiary of "Apex". Tr. p. 146.

29. "Roe" was responsible for the engineering, accounting, human resources, safety and the entire operations of the coal mining facilities, but did not report to anyone at "AEI". Tr. pp. 146-148.

30. The individual mine supervisors operated their mining facilities on a day-to-day basis and reported to the vice-president of operations. *Id*.

31. The budgets for the coal companies were formulated by the vice-president of operations and the members of his staff and the staffs at the mines without any input from "AEI". Tr. pp. 148-150.

32. The decisions on opening new mines and closing old ones, setting production goals, and deciding mining strategies and techniques were made by the vice-president of operations and his staff along with other departments within "Apex" without any input from "AEI". Tr. p. 150.

33. Purchase orders for equipment, etc., were made by the individual coal companies and sent to "Apex" for execution without any input from "AEI". Tr. pp. 153-156.

34. Contracts for the sale of coal were negotiated by the marketing department of "Apex" without any involvement of "AEI". Tr. pp. 157-159.

35. The coal companies negotiated and executed transportation agreements to move the coal from the mines to the customers without involvement of "AEI". Tr. pp.159-161.

36. Decisions regarding the use of research and development resources were made by the vice-president of research and development, his staff and

various departments of "Apothecary Coal Company" and "Apex" without any involvement of "AEI". Tr. pp. 161-162.

37. Advertising for the coal companies was handled by employees of "Apex". Tr. p. 163

38. Public relations, and environmental and government affairs were handled by departments within "Apex" that were headed by vice-presidents without any involvement of "AEI". Tr. pp. 163-164.

39. Training of mine workers was handled by the coal companies and "Apex" without any involvement of "AEI". Tr. p. 166.

40. Contracts with the United Mine Workers union were negotiated by the coal companies without any involvement of "AEI". Tr. pp. 167-170.

41. There was no communication between "AEI" and the coal companies regarding personnel matters such as salaries and fringe benefits. Tr. pp. 170-171.

42. "Apothecary Coal Company" and "Apex" shared common facilities in (Someplace), Pennsylvania. Tr. pp. 180-182.

43. "New Ulm Supply Company" and "Apothecary Coal Company" had authority to borrow up to $10 million, to open bank accounts, to purchase and sell marketable securities, to declare dividends and to conduct numerous other financial transactions all without the approval of "AEI". Tr. pp.193-199, 224; Taxpayer Group Exs. No. 3, 4, 5.

44. "New Ulm Supply Company" negotiated contracts with customers and suppliers without any approval from "AEI". Tr. pp. 200-208.

45. The salaries and fringe benefits for "Apex" employees were approved by the "Apex" human resources department with no involvement of "AEI". Tr. p. 209.

46. There were no exchanges of employees between "Apex" and "AEI". *Id*.

47. There was no communication between "Apex" and "AEI" regarding personnel matters. Tr. p. 210.

48. Insurance decisions for the coal companies were made by "Apex" without approval of "AEI". *Id.*

49. "Apex" did not share physical facilities with "AEI". *Id*.

50. There was no sharing of legal, accounting or computer systems between "Apex" and "AEI". Tr. pp. 210-211.

51. The only resolutions addressed by the "AEI" board of directors were for approval of its outside auditors, election of directors and appointment of officers, approval of annual loan amounts to subsidiary corporations, and dividends. Tr. pp. 240, 243.

52. The dividend amounts to be paid were determined by "Apex's" accounting personnel on the controller's staff. Tr. pp. 135, 219.

Conclusions of Law:

The Unitary Group Issue

The first remaining issue in this case is whether "AEI", the parent of "Apex", should be included in the unitary business group, that includes "Apex" and the coal group. The determination of whether a company should be included in a unitary group is a question of fact. Indications of a unitary business are functional integration, economies of scale, and direct transfers of value, because the contributions of each entity increase the taxable income of all of the other entities. Citizens Utilities Company of Illinois v. Dept. of Revenue, 111 Ill.2d 32, 48, 488 N.E.2d 984, 990 (1986). The taxpayer argues that these indicia of unity are almost non-existent in the relationship between "AEI" and "Apex" and its subsidiaries. The Department argues that there are sufficient indicia of unity to require "AEI" to be included in the unitary group. I recommend that "AEI" be included in the unitary group with "Apex" and its subsidiary corporations.

The section of the Act that defines the term “unitary business group” provides, in relevant part, as follows:

> Unitary business group. The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. . . . Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity. Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include

> exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member). . . . 35 ILCS 5/1501(a)(27).

This section of the statute sets forth two requirements for determining whether a group of corporations are a unitary business group within the meaning of the statute. The first requirement is that there must be common ownership, either direct or indirect, of more that 50% of the outstanding stock of the corporations in the group. In this case, "AEI" owns all of the outstanding stock of "Apex", so that criterion is satisfied and ownership is not an issue.

The second requirement addresses the business activity of the corporations in the group. It provides that "unitary business activity can **ordinarily be illustrated** where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); . . ." [Emphasis added.] 35 ILCS 5/1501(a)(27)

The statutory test to determine whether a group of entities that are engaged in the same line of business are unitary is to determine whether they are "functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member)." *Id*.

The Department's regulation, in relevant part, provides as follows:

> Strong centralized management Under IITA Section 1501(a)(27), no group of persons can be a unitary business group unless they are functionally integrated through the exercise of strong centralized management. It is this exercise of strong centralized management that is the primary indicator of mutual dependency, mutual contribution and mutual integration between persons that is necessary to constitute them members of the same unitary business group. The exercise of strong centralized management will be deemed to exist where authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member. Thus, some groups of persons may properly be considered as constituting a unitary business group under IITA Section 1501(a)(27) when the executive officers of one of the persons are normally involved in the operations of the other persons in the group and there are centralized units which perform for some or all of the persons functions which truly independent persons would perform for themselves. Note in this connection that neither the existence of central management authority, nor the exercise of that authority over any particular function (through centralized operations), is determinative in itself; the entire operations of the group must be examined in order to determine whether or not strong centralized management exists. A finding of "strong centralized management" cannot be supported merely by showing that the requisite ownership percentage exists or that there is some incidental economic benefit accruing to a group because such ownership improves its financial position. Both elements of strong centralized management, i.e., strong central management authority and the exercise of that authority through centralized operations, must be present in order for persons to be a unitary business group under IITA Section 1501(a)(27). Finally, a finding of strong centralized management can be supported even though the authority resides in a person that is not a member of the group, provided that the authority is actually exercised by such person. 86 Ill. Admin. Code § 100.9700 (g).

Under this regulation, groups of persons may properly be considered as constituting a unitary business group under IITA Section 1501(a)(27) when the executive officers of one of the persons are normally involved in the operations of the other persons in the group and there are centralized units which perform for some or all of the persons functions which truly independent persons would perform for themselves. By the terms of this regulation, neither the existence of central management authority, nor the exercise of that authority over any particular function (through centralized operations), is determinative in itself; the entire operations of the group must be examined in order to determine whether or not strong centralized management exists. Both elements of strong central management are required for persons to be a unitary business group, *i.e.*, there must be strong central management authority, and that authority must be exercised through centralized operations.

The evidence of record establishes that both elements of strong central management existed in this case. The ownership of all of "Apex's" capital stock by "AEI", with no restrictions on its ownership authority, gave "AEI" the strongest central management authority possible. The entire record in this case makes it reasonable to conclude that "AEI" exercised that authority by electing its own officers, with one exception, and its own directors as the officers and directors of "Apex" and by conferring on them management authority and control over the coal group. There is nothing in the statute or the regulations that allows or prevents the exclusion of a parent corporation from a unitary business group if it has delegated all of its management authority to a

subsidiary corporation which is functionally integrated with its subsidiary corporations as in this case.

In a typical unitary group of corporations, the parent corporation has assets, officers and employees that provide services to its subsidiary corporations in the areas of engineering property management, finance, environmental, planning, purchasing, accounting, tax, legal, computer use, research and development, safety and other administrative services. The corporate structure in the instant case does not match the typical pattern. In the instant case all of these functions reside in "Apex", a first tier subsidiary of "AEI", its parent. They reside in "Apex" because "AEI", its parent, exercising its complete management control, put them there.

Taxpayer's primary argument is that "Apex" and the coal group operated with almost complete independence from "AEI". For example, "AEI" and "Apex" did not exchange personnel. "AEI" did not approve the coal company contracts. "AEI" did not approve salaries or fringe benefits for the coal companies. "AEI" did not share accounting systems with the coal companies. "AEI" did not provide any engineering or research expertise to the coal companies. "AEI" did not approve the opening or closing of coal mines. "AEI" did not provide accounting, tax or legal services to "Apex" and the coal group. No one from "AEI" made any operational decisions for the coal companies. "AEI", being a holding company with no employees, could not perform any of these functions. Based these facts, taxpayer concludes that there is a lack of functional integration between "AEI" and "Apex" so "AEI" should not be included in the unitary business group with "Apex" and the coal group.

Taxpayer's argument fails, however, because it circumvents the purpose of combined reporting, and it ignores the underlying economic realities of the "AEI", "Apex", coal group corporate structure. Combined apportionment was developed for taxing a group of closely associated corporations that collectively engage in a multi-state business and constitute a unitary business group. General Telephone Co. of Illinois v. Johnson, 103 Ill.2d 363, 469 N.E.2d 1067 (1984). When an associated group of entities are engaging in the operation of a single business enterprise, formula apportionment on a combined basis is appropriate because a group of assets is used by the same overall entity for the generation of income through operation of a single unitary business. Citizens Utilities Company v. Dept. of Revenue, 111 Ill.2d 32, 488 N.E.2d 984 (1986). "If corporate forms were respected, state income taxation would be as artificially limited and open to manipulation as is the method of separate accounting." *Id.*, 111 Ill.2d at 40, 488 N.E.2d at 987.

In this case, to exclude "AEI" from the consolidated group would ignore the fact that it is an integral part of a multi-state business carried on by a group of related corporations. This would open the door to income manipulation as is possible under separate accounting, the very situation that combined reporting is intended to prevent. For example, if "AEI" is excluded from "Apex's" combined return, "AEI" could invest the cash it receives from its subsidiaries in marketable securities on a short term basis and avoid paying income tax on that income. In this scenario, no tax would be paid to Illinois because "AEI" has no gross receipts in Illinois, and no property or payroll anywhere, so none of the income would be apportioned or allocated to Illinois. The income would not

be taxed by Delaware because Delaware corporations are exempt from income tax under the Delaware statute if their activities are limited to maintaining and managing intangible investments, as is the case with "AEI". Del. Code Ann. Tit. 19, § 1902(b)(8). That is precisely the type of situation combined reporting is intended to prevent.

In addressing the question of whether income is apportionable, the U.S. Supreme Court has stated that it looks to the "underlying economic realities of a unitary business". Exxon Corp. v. Dept. of Revenue of Wisconsin, 447 U.S. 207, 223-224,100 S. Ct. 2109, 2120 (1980). "Apex", which was wholly owned by "AEI", and "AEI" shared the same officers, with one exception, and they had the same individuals serving on their boards of directors. To the extent "AEI" had business activities during the tax years, they were controlled by the officers and directors of "Apex" acting in their dual capacities as officers and directors of "AEI". To exclude "AEI" from the unitary business group at issue in this case would violate the fundamental principal of income tax law that requires the economic substance of a business arrangement to prevail over the corporate form of that arrangement. Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935); In Re: William Stoecker, 179 F3d 546 (7th Circ. 1999), *aff'd sub nom*. Raleigh v. Illinois Department of Revenue, 530 U.S. 15, 120 S.Ct. 1951 (2000). The economic reality is that "AEI", "Apex", and the coal group functioned as one economic unit.

The taxpayer argues further that the statute, the Department's regulations and case law state that if there is no functional integration between commonly owned companies, there is no flow of value, and that if there is no flow of value, there is no unitary business. In support of that argument, the taxpayer cites 35 ILCS 5/1501(a)(27); 86 Ill. Admin.

Code § 100.9700(g); Container Corp. of America v. Franchise Tax Bd., 163 U.S. 159 (1983); Citizens Utilities Co. v. Dept. of Revenue, *supra*; A. B. Dick Co. v. Dept. of Revenue, 287 Ill.App.3d 230, 678 N.E.2d 1100 (1997); Borden, Inc. v. Dept. of Revenue, 295 Ill.App. 3d 1001, 692 N.E.2d 1335 (1998); and Hormel Foods Corp. v. Dept. of Revenue, 316 Ill.App.3d 1200, 738 N.E.2d 145 (1st Dist. 2000).

These cases are factually distinguishable from the instant case, however. None of these cases involved a situation in which the common parent corporation was a holding company with no assets or employees, and with substantially the same roster of officers and the same individuals serving on their boards of directors. Each of the corporate structures of the cited cases that were determined to be unitary consisted of an active parent corporation with officers and directors and staffs that controlled and managed the businesses of their subsidiary corporations by exercising oversight and functional integration. In the case at issue, the parent company, "AEI", had no assets or employees to control or manage its subsidiaries. It shared officers with "Apex" and the two companies had interlocking boards of directors but they were not paid by "AEI". Because "AEI" was structured as a holding company with no active staff, the tests for functional integration cannot be applied to this case in the routine manner.

The principle that without functional integration between the parent and the subsidiaries there can be no flow of value and, therefore, no unitary business cannot be applied in the same way in a case such as the instant matter in which the parent corporation is established as a shell corporation that is structured so that all of the functions that demonstrate a flow of value are centered in a first tier wholly owned

subsidiary corporation that shares the same officers and directors with its parent corporation. The statute does not require that functional integration must always be demonstrated by showing a flow of value between the parent and its subsidiary companies. It only provides that it can ordinarily be shown in that manner.

In this case, the parent is a holding company, a shell corporation with no assets or employees. Its activities, which are minimal, are controlled by the officers and directors it shares with its subsidiaries. All of the control of the enterprise is centered in the subsidiary, "Apex", so no value can flow between the "AEI" and "Apex" in the ordinary manner. However, the underlying reality is that "AEI", "Apex" and its subsidiary corporations are an economic unit and, therefore, a unitary business enterprise.

The Penalty Issue

The final issue to be decided arises because the Department proposed a penalty under Section 1005 for underpayment of tax required to be shown on "Apex's" income tax return. Effective January 1, 1994, Section 1005 was amended so that the late payment penalty is now imposed under Section 3-3 of the Uniform Penalty and Interest Act. ("UPIA") 35 ILCS 735/3-1 *et seq*. Both sections provide for abatement of the penalty if the underpayment is due to reasonable cause. However, neither Section 1005 nor UPIA Section 3-8, which provides for abatement, defines reasonable cause.

The Department's regulations provide that reasonable cause is to be determined on a case by case basis taking into account all pertinent facts and circumstances. 86 Admin. Code ch., I, § 700.400 at ¶ (b). The most important factor is whether the

taxpayer made a good faith effort to comply with the law and if he exercised ordinary business care and prudence in doing so. *Id*. at ¶ (c).

Taxpayer argues that it obtained a ruling letter from the tax authorities of West Virginia in 1992, before the taxpayer's Illinois income tax return was filed for that year, which determined that "AEI" was not unitary with "Apex" under the West Virginia statute. "Apex's" state tax manager testified that the letter figured prominently in the taxpayer's decision to exclude "AEI" from it unitary group in its Illinois income tax returns. Taxpayer acknowledges that the letter is not binding in Illinois, but argues that it was reasonable to conclude that the same result would obtain in Illinois. Taxpayer concludes that this demonstrates sufficient reasonable cause to justify abatement of the penalty. Taxpayer did not argue about any penalty assessed as a result of the other adjustments that it has conceded.

The primary issue in dispute in this matter is whether a parent corporation that has no assets, employees or officers, the primary function of which is to own the stock of its operating subsidiaries, is a member of the unitary group consisting of its operating subsidiaries. There is no relevant case law in Illinois addressing this issue and the issue is not specifically addressed in the statute or in the Department's regulations. Absent any Illinois authority, taxpayer relied on a ruling letter from West Virginia that held that "AEI" was not includible in the unitary group.

Giving consideration to the factors noted above, I conclude that the taxpayer acted in good faith and exercised reasonable care and prudence. Therefore, there is reasonable

cause for abating the penalty to the extent that it is based on the exclusion of "AEI" from the combined return.

Conclusion and Recommendation

For all of the reasons set forth above, I conclude that "AEI" is a member of the "Apex" unitary group. Penalties should be abated to the extent they would result from exclusion of "AEI" from taxpayer's unitary group.

I recommend that the Notices of Deficiency be recalculated to reflect the agreement of the parties regarding "Apex" Foreign Sales Corporation and the adjustments resulting from the issues conceded by the taxpayer; that "AEI" be included in the "Apex" unitary group; that penalties be recalculated; and that, as so adjusted, the Notices of Deficiency should be made final.

ENTER: October 24, 2001

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Administrative Law Judge